REVENUE RECOGNITION FOR FRANCHISORS

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1. Introduction

In 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)* to provide a robust framework and comprehensive principles for addressing revenue recognition accounting. Additionally, the guidance on accounting for certain costs related to a contract with a customer in the scope of Topic 606 was codified in ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers (Topic 340-40).*

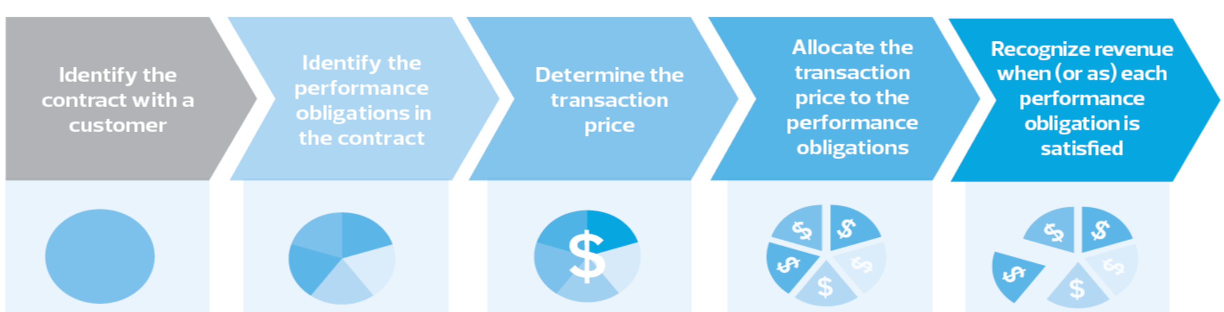
While virtually all aspects of ASC 606 and ASC 340-40 are relevant to franchisors, this white paper highlights aspects of the guidance that are particularly pertinent to these entities. For additional information about all of the revenue recognition guidance, including those aspects discussed in this white paper, as well as numerous examples illustrating how to apply the guidance, refer to our revenue recognition guide.

Following the release of ASC 606, the American Institute of Certified Public Accountants (AICPA) organized several industry-specific task forces, including one focused on the hospitality industry (including franchisors), to identify and provide guidance on revenue recognition implementation issues. The culmination of the AICPA task forces' activities was the issuance in 2019 of a final comprehensive nonauthoritative revenue recognition guide (the Revenue Recognition AAG) that provides helpful discussion and illustrative examples on how to apply the guidance.

The sources of revenue and nature of operations of a franchisor differ greatly from that of a restaurant or retailer operating company-owned units. As a result, franchisor accounting, including revenue recognition, is unique. Topics that may be impacted by, or need to be analyzed under, the guidance in ASC 606 include: specific services to be provided under an area development agreement, which is an agreement in which the franchisor is providing the opportunity for a franchisee to operate a certain number of units within an agreed-upon geographic area; treatment of initial franchise fees, especially if ongoing obligations of the franchisor exist in the franchise agreement; and revenue recognition for franchisors relating to advertising (or brand) fund fees which franchisees may be required to contribute into an advertising fund based on a percentage of their net sales and which, along with any contributions to the fund from the franchisor (if the franchisor also operates its own units), are expended on system-wide marketing.

2. Core Principle and Key Steps

To put the specific aspects of the revenue recognition guidance discussed in this white paper into proper context, it is important to know that the core principle included in the guidance (ASC 606-10-10-2) is to "recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." In addition, the guidance sets out the following steps for an entity to follow when applying the core principle to its revenue-generating transactions:



3. Step 1: Identifying the Contract With a Customer

A contract is defined in ASC 606-10-25-2 as “an agreement between two or more parties that creates enforceable rights and obligations.” To account for a contract in accordance with the guidance, the following five contract existence criteria must be met:

- Approvals have been obtained and a commitment to perform exists on the part of both parties
- Rights of both parties are identifiable
- Payment terms are identifiable
- Commercial substance exists
- Collection of substantially all of the amount to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur)

For franchisors, area development agreements or individual franchise agreements will almost certainly be in place. That said, the preceding specific criteria must be met for the agreements to move forward to the next step in the revenue recognition model. Each agreement will need to be analyzed to determine whether these criteria are met.

One of the criteria that must be met requires an assessment of whether it is probable the franchisor will collect the amount to which it will be entitled for goods and services that will be transferred to the customer. With many area development and initial franchise agreements, fixed payments occur in advance of or at the time of signing the related agreements. There would be no franchisor collection risk associated with those fixed payments. Given the typical payment terms for ongoing royalty fees included in an area development or initial franchise agreement, such fees will need to be evaluated by the franchisor. This assessment should consider all relevant facts and circumstances, including whether the franchisor can mitigate its credit risk through its ability to stop transferring promised goods or services upon nonpayment by the customer.

When all of the contract existence criteria are met, the remaining steps in the five-step revenue recognition model are applied to the contract. When all of the contract existence criteria are not met, revenue is deferred and the contract existence criteria continue to be evaluated to determine whether they are subsequently met. Absent meeting the contract existence criteria, revenue is only recognized under very limited circumstances, which could result in the initial deferral of revenue for what may be a significant period of time, even if nonrefundable cash has been received.

3.1 Combining contracts

If one or more of the following criteria are met, individual contracts with the same customer (or parties related to the customer) that are entered into at or near the same time are combined for accounting purposes:

- The contracts were negotiated as a package and share the same commercial objective
- The consideration to be paid under one contract is tied to the other contract’s price or performance
- Some or all of the goods or services in one contract and some or all of the goods or services in the other contracts represent a single performance obligation (i.e., some or all of the goods or services in each contract are not distinct from each other)

Franchisors frequently enter into franchise agreements that also refer to franchise disclosure documents (FDDs). Paragraph 17.6.08 of the Revenue Recognition AAG indicates that the franchise agreement and the FDD generally should be combined and accounted for as a single contract.

3.2 Contract modifications

Changes or updates may be made to the contract during the life of the contract or relationship with the customer. Such changes should be assessed to determine if they are contract modifications that impact the accounting for the contract. The accounting model applied to a contract modification under ASC 606 depends on a number of factors, including the pricing of the modification, whether any new products or services added by the modification are distinct and whether any of the remaining goods or services are part of a partially satisfied single performance obligation. Consult section 5.5 of our revenue recognition guide for further details on the accounting for contract modifications.

4. Step 2: Identifying Performance Obligations in the Contract

After contract identification (Step 1), a franchisor needs to identify the performance obligations in the contract (Step 2). Identifying the performance obligations in the contract establishes the units of account to which the transaction price should be allocated and for which revenue is recognized.

4.1 Identifying promises to transfer goods or services

The first step in identifying the performance obligations in the contract is to identify all promises to provide goods or services. A franchisor should scrutinize its customer contracts and identify all the promises to transfer goods or services to the customer. Consideration also needs to be given to whether there are promises to transfer goods or services that arise out of a franchisor's customary business practices instead of an explicit contract provision.

Not all activities performed by the franchisor in connection with the contract transfer a good or service to the customer. For example, setup activities do not transfer a good or service to the customer. Instead, those activities are necessary for the franchisor to fulfill the contract and do not themselves represent a good or service transferred to the customer. As a result, they cannot represent a performance obligation.

4.2 Separating promises to transfer goods or services into performance obligations

If there is more than one promise to transfer goods or services in a contract, consideration must be given to whether the promises to transfer goods or services should each be considered performance obligations and accounted for separately. The determining factor in this analysis is whether each promised good or service is distinct. If a promised good or service meets both of the following criteria, it is considered distinct: (a) it is capable of being distinct and (b) it is distinct within the context of the contract. A promised good or service that is considered distinct is accounted for separately as a performance obligation unless the series exception applies. For additional information about the series exception, refer to Section 6.3 of our revenue recognition guide.

4.2.1 Capable of being distinct

If a customer can benefit from the promised good or service on its own or by combining it with other resources readily available to the customer, the good or service is capable of being distinct. A promised good or service is capable of being distinct when the franchisor regularly sells that good or service separately or when the customer could generate an economic benefit from using, consuming, selling or otherwise holding the good or service for economic benefit either on its own or when combined with other readily available resources. For a resource to be readily available to the customer, it must be sold separately either by the franchisor or another party, or it must be a good or service that the customer already has obtained as a result of either a contract with the franchisor (including the contract under evaluation) or another transaction or event.

4.2.2 Distinct within the context of the contract

To determine whether a promised good or service is distinct within the context of the contract, the franchisor must ascertain which of the following best describes its promise within the context of the specific contract:

- *The promise in the contract is to transfer the promised good or service individually*. If this best describes the franchisor's promise within the context of the specific contract, the promised good or service is distinct within the context of the contract.
- *The promise in the contract is to transfer a combined item or items to which the promised good or service is an input.* If this best describes the franchisor's promise within the context of the specific contract, the promised good or service is not distinct within the context of the contract.

Indicators are provided to assist in determining whether a promised good or service is distinct within the context of the contract. Answering yes to any of the following questions is an indication that the promised good or service is *not* distinct within the context of the contract:

- Is the franchisor providing a significant service of integrating the promised good or service with one or more of the other promised goods or services in the contract, with the result of that integration being one or more of the combined outputs contracted for by the customer?
- Does the promised good or service significantly modify or customize one or more of the other promised goods or services in the contract, or is the promised good or service significantly modified or customized by one or more of the other promised goods or services in the contract?
- Is the promised good or service highly interdependent or highly interrelated with one or more of the other promised goods or services in the contract, such that each of the promised goods or services is significantly affected by one or more of the other promised goods or services? Another way to think of this question is can the franchisor satisfy each of the promises in the contract independent of its efforts to satisfy the other promises?

If a promised good or service is distinct, it is considered a performance obligation and accounted for separately. However, a series of distinct promised goods or services that are substantially the same should be considered a *single* performance obligation and accounted for as one unit of account if each of the goods or services has the same pattern of transfer to the customer as a result of (a) each of the goods or services otherwise being considered satisfied over time and (b) the franchisor otherwise having to use the same method of measuring progress toward completion for each of the goods or services.

If a promised good or service is not distinct, it is combined with other promised goods or services until the group of promised goods or services is considered distinct, at which point that group is considered a performance obligation and accounted for separately. It is possible that all of the promised goods or services in the contract might have to be accounted for as a single performance obligation. This happens when none of the promised goods or services are considered distinct on their own or together with less than all of the other promised goods or services in the contract.

4.2.2.1 License

Franchise agreements include a right to use the franchisor's intellectual property (e.g., trade name) for a period of time. Because the intellectual property has value primarily due to its association with the franchisor's past or ongoing activities, it is considered symbolic intellectual property (IP). Paragraph 17.6.14 of the Revenue Recognition AAG indicates that although the license is capable of being distinct because the franchisor can benefit from the license on its own or with other available resources, it is generally highly interdependent on or highly interrelated with other promised goods and services in the contract and therefore usually will be combined with other goods or services in the contract.

Further, as noted in paragraph 17.6.25 of the Revenue Recognition AAG, the license represents a series of distinct services, which is the franchisor's promise to provide daily access to the license over a period of time. While the underlying activities vary day to day, each day is distinct in that the franchisee benefits from each day's right to access the license and the license is satisfied over time as the customer simultaneously receives and consumes the benefit from the franchisor's performance of providing access.

4.2.2.2 Advertising fund

Many franchisors also establish an advertising fund. The franchise agreement typically discusses the manner in which advertising fees are to be calculated and remitted to the franchisor (typically as a percentage of sales, paid concurrently with royalties) and how the fees will be used by the franchisor. The services covered by these fees usually consist of marketing and reservation activities that are performed at the brand level and not on an individual franchisee basis. Paragraphs 17.6.20 and 17.6.21 of the Revenue Recognition AAG indicate that these promises should be combined with the license because the marketing and reservation activities do not relate to the individual franchisee but generally enhance the value of the intellectual property included in the license.

4.2.2.3 Pre-opening services

Individual franchise agreements typically include, among other services, site selection (if not already covered under the area development agreement); review and approval of architectural and design plans; access to proprietary manuals and handbooks, equipment, training and pre-opening assistance (and in some cases an opening team for a period of time after the grand opening); and, most importantly, use of the franchisor's IP (e.g., trade name). Franchisors will need to evaluate these services to determine whether they are distinct from the license.

Paragraphs 17.6.30 through 17.6.34 of the Revenue Recognition AAG indicate that certain pre-opening services, such as brand signage and property inspection, generally should be combined with the license and system assessment services and accounted for as a single performance obligation that is a series of distinct goods or services. However, some pre-opening services, such as architectural design services, training or property improvement plans, may be considered distinct depending on the specific facts and circumstances.

There are no presumptions on how many performance obligations are included in an individual franchise agreement or an area development agreement. Facts and circumstances often will differ from contract to contract, but in many cases it is likely that, other than equipment, the activities undertaken by the franchisor either will not represent promised goods or services because they are essentially setup activities or will not be considered distinct promised goods or services because, without the license of the IP, they provide little to no benefit on their own (or together with other readily available resources) or they cannot be separately identifiable from the license of the IP. Therefore, in many cases, the license of IP will be combined with other promised goods or services as one performance obligation. Paragraphs 17.6.12 through 17.6.34 of the Revenue Recognition AAG discuss the application of these criteria to the promises in a typical franchise agreement.

See Section 4.2.3 for discussion regarding a practical expedient that permits a franchisor that is not a public business entity to account for certain pre-opening services provided to a franchisee as distinct from the franchise license.

4.2.2.4 Area development agreements

Area development agreements (ADAs) provide the franchisee the rights to a defined geographic territory. They typically include a required minimum number of units to be opened and specify a time frame during which no other franchisee can operate in the defined geographic territory. In some instances, ADAs require the franchisor to review the proposed site and related lease or purchase agreement for each unit before giving the franchisee consent to proceed with construction. In general, a franchisee will pay an upfront fee to enter into an ADA and then will enter into a separate franchise agreement as each unit is opened.

When determining the promises in an ADA, a franchisor will need to exercise significant judgment when identifying performance obligations. The assessment of whether an ADA creates additional performance obligations prior to the execution of the individual franchise agreement, how many performance obligations are identified in an ADA and the ultimate timing of recognition may vary depending on the facts and circumstances, including whether there is a specified or unlimited number of units that may be opened and whether the franchisee has the right to subfranchise within a designated area.

4.2.2.5 Customer loyalty programs

Many franchisors administer customer loyalty programs. Franchisors should determine whether the option for additional goods or services provided in a customer loyalty program is a material right that the customer would not have received had it not entered into the contract with the franchisor. When evaluating whether an option provides a material right, the franchisor should consider both quantitative and qualitative information about the customer loyalty program as well as all relevant transactions related to the customer loyalty program, including current, past and future transactions.

Example 4-1: Evaluating whether a specific loyalty program includes an option that provides the customer with a material right (Question 12 of FASB's Revenue Recognition Implementation Q&As)

Entity A has a loyalty program in which its customers accumulate one point for every dollar spent. Points may be exchanged for free products when the customer accumulates enough points. Based on its historical data, Entity A determines that it is likely that its customers will accumulate enough loyalty points to receive a free product.

In the current transaction, Customer Y purchases a product from Entity A for $50 and receives 50 loyalty points. Entity A concludes that each loyalty point has a standalone selling price of $0.01.

Entity A would consider whether the loyalty points earned from the current transaction are expected to contribute to a material right that the customer has (or will accumulate). The evaluation would consider that an element of the right granted to Customer Y in the current transaction is the customer's ability to accumulate loyalty points that will entitle the customer to a free product.

RSM COMMENTARY: By tying whether a material right exists in this example to the customer's ability to accumulate loyalty points on future transactions, the TRG and FASB staff rejected the position that if the loyalty points earned in the current transaction are not enough to entitle the customer to a benefit (e.g., free hotel room stay, $100 discount), then they do not provide the customer with a material right.

4.2.3 Private company practical expedient for certain pre-opening services

In January 2021, the FASB issued ASU 2021-02, *Franchisors—Revenue from Contracts with Customers (Subtopic 952-606): Practical Expedient*, to help reduce the cost and complexity of applying the revenue recognition guidance for certain franchisors. This ASU provides a practical expedient in ASC 952-606-25-2 that permits a franchisor that is not a public business entity (PBE) that enters into a franchise agreement to account for the following pre-opening services provided to a franchisee as distinct from the franchise license:

- Assistance in the selection of a site

- Assistance in obtaining and preparing the facilities for their intended use, including related financing, architectural and engineering services and lease negotiation
- Training of the franchisee and their personnel
- Preparation and distribution of manuals and similar material concerning operations, administration and record keeping
- Bookkeeping, information technology and advisory services, including setting up the franchisee's records and advising the franchisee about income, real estate and other taxes and about regulations affecting the franchisee's business
- Inspection, testing and other quality control programs

If a franchisor elects to use the practical expedient, the franchisor will have to determine whether the pre-opening services are distinct from one another, unless it makes an accounting policy election to account for the pre-opening services as a single performance obligation.

This practical expedient only applies to identifying performance obligations and does not impact the remaining aspects of applying the guidance on recognizing revenue from contracts with customers, including allocating the transaction price and recognizing revenue. In other words, franchisors will still need to estimate the standalone selling price of the pre-opening services in order to appropriately allocate revenue, and will need to apply the guidance in Step 5 to determine the timing and pattern of revenue recognition. If a franchisor makes the policy election to account for the pre-opening services as a single performance obligation, it will need to select a single measure of progress to apply to the pre-opening services performance obligation.

Franchisors that elect the expedient should apply it consistently to contracts with similar characteristics and in similar circumstances and cannot apply it to services other than those pre-opening services specifically identified in the list above. Any services provided that are not consistent with the list of services noted above should be evaluated under the guidance in Step 2 to determine whether the services are distinct and should be accounted for as separate performance obligations.

5. Step 3: Determining the Transaction Price

5.1 General requirements for determining the transaction price

Transaction price is defined in ASC 606-10-32-2 as "the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes)." The transaction price is the amount to which the franchisor expects to be entitled for the goods and services that will be transferred to the customer in connection with the area development or individual franchise agreements. The transaction price in a typical franchise arrangement would include any upfront fees, as well as royalty and advertising fund fees. While the royalty and advertising fund rates generally are stated in the agreements, the timing of when they are included in the transaction price depends on whether they are subject to the sales and usage-based royalties constraint on licenses of IP. Paragraph 17.6.37 of the Revenue Recognition AAG indicates that the license to the franchisor's intellectual property generally is the predominant deliverable in the combined performance obligation. As a result, the royalty and advertising fees are subject to the sales- and usage-based royalties constraint and will only be included in the transaction price and recognized as revenue at the later of when the sale or usage occurs or the related performance obligation is satisfied.

In determining the transaction price, franchisors also must consider whether there is a significant financing component. Franchisors should note that a significant financing component does *not* exist in any of the following situations:

- The customer makes an advance payment and when the promised goods or services are transferred to the customer is at the customer's discretion
- There is substantial variable consideration, and payment of that consideration is contingent on the resolution of an uncertainty that is not substantially in the franchisor's or customer's control
- There are reasons not related to financing that justify the nature and amount of the difference between the cash selling price of the promised goods or services and the promised consideration

ASC 606-10-32-18 includes a practical expedient that allows an entity to not adjust the transaction price for a significant financing component if, at contract inception, the entity expects to collect payment from the customer within one year from the time the good or service is transferred.

Although area development and franchise fees typically are due in advance, paragraph 17.6.38 of the Revenue Recognition AAG indicates that such fees generally do not result in the identification of a significant financing component because the difference in timing of the payment is to protect the franchisor in the event the franchisee fails to complete its obligations under the contract (e.g., the franchisee does not open a location after initial services are provided).

6. Step 4: Allocating the Transaction Price to the Performance Obligations

6.1 Overall allocation model

Step 4 of the five-step revenue recognition model in ASC 606 requires a franchisor to allocate the transaction price (determined in Step 3) to each performance obligation in the contract (identified in Step 2).

The overall objective of the guidance on allocating the transaction price is to allocate an amount to each performance obligation (or distinct good or service in a single performance obligation resulting from the series exception (refer to Section 6.3 of our revenue recognition guide) that represents the consideration to which the franchisor expects to be entitled as a result of transferring control of the underlying goods or services to the customer.

If a contract has more than one performance obligation, the transaction price generally should be allocated to each performance obligation based on the standalone selling prices of each performance obligation in relation to the total of those standalone selling prices (i.e., on a relative standalone selling price basis). Exceptions are provided for certain situations involving discounts or variable consideration that can be shown to be related to one or more (but less than all) performance obligations. In addition, a contract with one performance obligation also may be affected by the guidance on allocating variable consideration when that one performance obligation is made up of a series of distinct goods or services that are treated as a single performance obligation under the series exception.

6.2 Standalone selling prices

The standalone selling price of a performance obligation is the amount the franchisor charges (or would charge) when the distinct goods or services that make up the performance obligation (i.e., the underlying distinct goods or services) are sold on their own to a customer. Standalone selling prices are determined at contract inception and are not subsequently adjusted for changes in facts and circumstances.

The best evidence of the standalone selling price of the underlying goods or services is the observable price charged by the franchisor for those goods or services when they are sold separately in similar circumstances to similar customers. Absent evidence of a directly observable standalone selling price, the franchisor is required to estimate a standalone selling price. While there are any number of approaches to estimating a standalone selling price that are consistent with the overall objective of allocating the transaction price, ASC 606 discusses the following three approaches:

- Adjusted market assessment approach
- Expected cost plus a margin approach
- Residual approach

In making this estimate, the franchisor should maximize observable inputs and consider all reasonably available and relevant information, which includes information specific to the franchisor, the market, the customer and the customer class. In addition, a franchisor should be consistent in how it applies an estimation method and the situations in which it applies an estimation method.

6.3 Allocating variable consideration

Variable consideration included in the transaction price should be allocated on a proportionate basis to each of the performance obligations in a contract, except when the following two criteria are met:

- The terms of the variable payment are specifically related to the franchisor's efforts to (a) satisfy, or achieve a specific outcome from satisfying, a specific performance obligation or (b) transfer, or achieve a specific outcome from transferring, a distinct good or service in a single performance obligation resulting from application of the series exception
- Allocating the variable payment to the specific performance obligation, or distinct good or service in a single performance obligation resulting from the series exception, depicts the amount of consideration to which the franchisor expects to be entitled in exchange for transferring that good or service to the customer when considering all of the performance obligations and payment terms in the contract

When these criteria are met, the variable payment included in the transaction price that meets these criteria, and any change in the estimate of that payment, should be allocated in their entirety to the specific performance obligation or distinct good or service to which the variable payment relates.

Franchise agreements typically are structured to align compensation with the related services. For example, variable license fees and system assessment fees generally relate to satisfying the license obligation for the period in which they are assessed. Paragraph 17.6.43 of the Revenue Recognition AAG indicates that if the performance obligation is a series of daily services for which the uncertainty regarding the consideration is resolved on a daily basis, then the allocation of the monthly variable royalty and system assessment fees to the daily services provided during the month they are billable is consistent with the allocation objective. The Revenue Recognition AAG also notes that, as a practical expedient, if the franchisor has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the franchisor's performance completed to date, the franchisor may recognize revenue in the amount to which it has a right to invoice.

Given the relative significance of the license of the IP in area development and initial franchise agreements, it will not be uncommon for a majority of the transaction price to be allocated to the performance obligation that includes the license of the IP. In situations where multiple performance obligations exist, care will need to be exercised to ensure appropriate allocation of the transaction price.

Appropriately allocating the transaction price in a franchise arrangement that includes multiple performance obligations is important. For example, consider a franchise agreement in which two performance obligations are identified: the license of IP and training services. The transaction price consists of an upfront fee and a sales-based royalty. If the standalone selling price of the training service is more than the upfront fee, the entire fee would be recognized upfront and the royalty would be recognized as earned because the guidance in ASC 606-10-55-65 does not allow sales-based royalties on IP to be recognized upfront. If, however, the standalone selling price of the training service is less than the upfront fee, then a portion of the fee would be deferred and recognized as revenue over the term of the license. Example 8-6 in our revenue recognition guide provides a detailed numerical example illustrating how to allocate the transaction price when the contract includes the license of IP and variable consideration.

7. Step 5: Recognizing Revenue When (or As) Each Performance Obligation is Satisfied

Revenue is recognized when (or as) a performance obligation is satisfied, which is when control of the underlying good or service (i.e., an asset) is transferred to the customer. The amount of revenue recognized upon satisfaction of a performance obligation is the transaction price allocated to it.

To properly assess when revenue should be recognized, a franchisor must perform at contract inception an evaluation focused on whether a performance obligation is satisfied over time or at a point in time.

If a performance obligation meets one or more of the following criteria, it is considered satisfied over time:

- *Customer simultaneously receives and consumes benefits as the franchisor performs.* A performance obligation is satisfied over time if the customer consumes the benefits of the franchisor's performance at the same time as: (a) the customer receives those benefits and (b) the franchisor performs and creates those benefits. If it is not readily apparent whether this criterion is met in a particular situation, then a performance obligation is satisfied over time if another entity could step in and fulfill the remaining performance obligation without having to substantially reperform the work already performed by the franchisor.
- *Customer controls the asset as the franchisor creates or enhances the asset.* A performance obligation is satisfied over time if the customer controls the asset (which could be tangible or intangible) as it is created or enhanced by the franchisor's performance.
- *No alternative use and an enforceable right to payment for performance to date.* A performance obligation is satisfied over time if: (a) the asset created by the franchisor's performance does not have an alternative use to the entity upon its completion and (b) the franchisor's right to payment for its performance to date is enforceable.

If a performance obligation does not meet any of these three criteria, then it is considered satisfied at a point in time and revenue is recognized at the point in time the customer obtains control over the underlying good or service.

7.1 Identifying a method to measure progress toward complete satisfaction of a performance obligation made up of multiple promised goods or services that are not distinct

When a promised good or service in a contract is not distinct, it is combined with other promised goods or services in the contract until a bundle of promised goods or services is identified that is distinct. (This often is the case in a franchise agreement.) The result is a performance obligation made up of multiple promised goods or services. In many cases, these performance obligations will meet one of the criteria that results in recognizing the revenue related to the performance obligation over time. The difficulty that may then arise in these cases is identifying an appropriate method for measuring progress toward the complete satisfaction of the performance obligation. The FASB staff and TRG discussed this difficulty and a summary of the discussions is provided in Question 48 of FASB's Revenue Recognition Implementation Q&As.

The FASB staff and TRG concluded that a franchisor must identify a single method by which to measure progress toward the complete satisfaction of a performance obligation even when the performance obligation is made up of a bundle of promised goods or services. In other words, a franchisor may not identify different methods to apply to different nondistinct goods or services for purposes of measuring its progress toward the complete satisfaction of the performance obligation as a whole. To do so likely would circumvent the reasons the promised goods or services were bundled together to form one performance obligation in the first place.

Ultimately, the franchisor's goal is to identify a method for measuring progress toward the complete satisfaction of a performance obligation that achieves the intended objective, which is to "depict an entity's performance in transferring control of goods or services promised to a customer." Identifying this method will require a franchisor to exercise significant judgment and carefully consider all the facts and circumstances.

Example 7-1: Identifying a method for measuring progress to completion for a performance obligation consisting of a franchise license and consulting services (Question 48 of FASB's Revenue Recognition Implementation Q&As)

A franchisor enters into a 10-year license agreement with a new franchisee. The franchisor also promises to provide consulting services over the first year of the license agreement. The consulting services provide the franchisee with hours of service to help it set up operations to run its franchise.

For the purpose of this example, it is assumed that the franchisor concludes that the license and services should be combined into a single performance obligation because the license and services are highly interrelated (that is, each promise is capable of being distinct because the customer can derive some benefit from each item — from the franchise license on its own and the services together with the license granted upfront — but the promises are not distinct in the context of the contract). Furthermore, the entity concludes that the license is satisfied over time.[footnote omitted] The transaction price consists of an upfront fee of CU1 million for the license and CU150,000 for a fixed number [of] hours of consulting service that are performed in the first year.

In the staff's view, the entity should use a measure of progress that best depicts the performance of the license. The nature of the overall performance obligation is the franchisee's right to access the license and, therefore, the measure of progress would depict the transfer of the license. For example, using a time-based output method, the entire transaction price would be recognized ratably over the 10-year period. The entire transaction price of CU1,150,000 would be recognized over the 10-year license agreement.

RSM COMMENTARY: One of the views rejected by the FASB staff and TRG would have used a measure of progress depicting the performance of the consulting services in the first year of the license agreement. The FASB staff and TRG rejected this view because it essentially would ignore the right to access the IP subject to the license over the last nine years of the ten-year license period. The other view rejected by the FASB staff and TRG would have recognized the license fee over the license period and the consulting services fee as each hour of service is transferred to the customer. One of the reasons this view was rejected was because it circumvented the reasons why the franchise license and consulting services were bundled together as one performance obligation.

7.2 Sales- or usage-based royalties

The overall variable consideration guidance in ASC 606 should not be applied to a sales- or usage-based royalty when the only, or predominant, item to which the royalty relates is the license of IP. As noted in paragraph 17.6.44 of the Revenue Recognition AAG, in most franchise agreements, the promises to perform system assessment services and non-distinct pre-opening services should be bundled with the license to form a single performance obligation. Because the license is considered the predominant item in the bundled performance obligation, the royalties received related to the license should not be included in the transaction price until the later of the resolution of the related uncertainty (i.e., sales or usage occur) or the satisfaction of the related performance obligation in whole or in part.

Any additional products or services that are not included in the combined performance obligation in which the license is the predominant deliverable should be evaluated under the general guidance in ASC 606 to assess when control is transferred.

It should be noted that the point in time at which the franchisor receives sales data from its customers has no bearing on when the franchisor includes royalties related to those sales in the transaction price. As discussed earlier, royalties subject to the sales- or usage-based royalties exception should not be included in the transaction price until the later of the resolution of the related uncertainty (i.e., sales or usage occur) or the satisfaction of the related performance obligation in whole or in part. If the franchisor does not yet have the sales data from its customer upon the later of those two events happening, it should estimate the royalties to which it expects to be entitled for purposes of including them in the transaction price at that point in time. This answer is consistent with the views expressed by an SEC staff member in his remarks before the 35th Annual SEC and Financial Reporting Institute Conference in June 2016.

If there is a subsequent change in the franchisor's estimate of the royalties to which it expects to be entitled as a result of receiving the sales data from the customer, the franchisor should account for that change as it would account for any other change in the transaction price.

7.3 Gift card programs

Many franchisors sell gift cards that are redeemable at company-owned and franchise locations. ASC 606 only addresses gift cards redeemed at company-owned locations. Gift cards redeemed at franchise locations are within the scope of ASC 405, *Liabilities,* which requires the same accounting treatment for unredeemed gift cards (i.e., breakage) as that in ASC 606.

Gift cards provide for the customer to prepay for goods or services, which obligates the franchisor to provide or stand ready to provide those goods or services. The prepayment should be recognized as a contract liability. Revenue is recognized by derecognizing the contract liability when the customer exercises its rights by redeeming the gift card at a company-owned location in the future. When gift cards are redeemed at a franchise location, the franchisor typically reimburses the franchisee for the gift card value net of any administrative costs and derecognizes the related liability at that time. However, customers do not always exercise all of the rights for which they prepaid. Those rights that go unexercised are referred to as breakage.

To the extent a franchisor expects to be entitled to an amount of breakage, that amount should be proportionately recognized as revenue as the other performance obligations in the contract (i.e., those contractual rights expected to be exercised by the customer) are satisfied. However, the franchisor will need to apply the variable consideration constraint and conclude it is probable that a significant reversal in cumulative revenue recognized will not occur as a result of proportionately recognizing breakage as revenue as the other performance obligations in the contract are satisfied. When the franchisor does not proportionately recognize all breakage as revenue as the other performance obligations in the contract are satisfied (perhaps because of the variable consideration constraint), the transaction price related to that breakage should not be recognized as revenue until the likelihood that the customer will exercise those rights becomes remote. However, when the franchisor does not expect to be entitled to an amount of breakage because it is required to remit amounts received related to a customer's unexercised rights to another party (e.g., a governmental authority), it should recognize a liability for those amounts.

Example 7-2: Accounting for breakage related to gift cards when it can be reasonably estimated, and there is no escheatment law

While this example addresses the accounting for a single gift card (for ease of illustration), the same approach should be used if a franchisor elects to account for a portfolio that includes a large volume of similar gift cards.

Customer B buys a $50 gift card from Franchisor A. The gift card expires in one year, and Franchisor A enforces the expiration date.

Based on its historical data, Franchisor A estimates that Customer B only will use $45 of the gift card and that $5 will go unused. Franchisor A concludes it is probable that recognizing $1.11 of revenue ($50 gift card ÷ $45 expected to be redeemed) per $1 of gift card value redeemed will not result in a significant reversal of cumulative revenue recognized when the uncertainty related to how much of the gift card is used before its expiration is resolved. There are no escheatment laws in the state in which the gift card was sold or used that require Franchisor A to pay the state proceeds from the sale of gift cards that are unused.

When Franchisor A sells the gift card to Customer B, it records the following journal entry:

	Debit	Credit
Cash	$50	
Contract liability		$50

When Customer B uses the gift card six months later to purchase a meal for $30 at a franchisor-owned location, Franchisor A records the following revenue-related journal entry:

	Debit	Credit
Contract liability (Note 1)	$33	
Revenue (Note 1)		$33

Note 1: $30 gift card value redeemed × $1.11 of revenue per $1 gift card value redeemed

Company A still expects $15 of the remaining value on the gift card to be redeemed and the other $5 of the remaining value to expire unused.

8. Presentation of Advertising Funds

Under ASC 606, the overall principle with respect to gross vs. net presentation of revenue focuses on whether the franchisor controls the specified goods or services before they are transferred to a customer. If so, the franchisor is acting as a principal and should include the gross amount of consideration related to each of the specified goods or services in the transaction price (which is the amount ultimately recognized as revenue). If not, the franchisor is acting as an agent and should include the net fee or commission it expects to be entitled to for arranging to have another party provide the specified good or service to the customer in the transaction price.

The same analysis used to identify the performance obligations in a contract is also used to identify the specified goods or services to which the principal vs. agent guidance is applied when another party is involved in providing those goods or services to the customer. As such, identifying the specified goods or services involves identifying all of the promises to provide goods or services in the contract and then determining whether those promised goods or services are distinct. The concept of distinct used for this purpose is the same as the concept of distinct used to identify performance obligations (see Section 4.2).

If a promise to provide a good or service is distinct, it is considered a specified good or service, and the entity must determine whether it is acting as a principal or an agent with respect to providing the good or service to the customer. If a promise to provide a good or service is not distinct, it is combined with one or more other promises to provide goods or services until the combined group is considered distinct.

Under ASC 606, advertising fund fees are generally recorded gross within revenue, as the advertising fund fees generally will not be considered payment for distinct services that are separable from the license of the IP.

9. Contract Costs

9.1 Scope

A franchisor may incur costs to obtain or fulfill a franchise agreement. The guidance for recognizing these contract costs as an asset is codified in Topic 340-40. ASC 340-40 addresses the circumstances under which certain costs that arise in conjunction with performing under contracts within the scope of ASC 606 should be capitalized. The guidance in Topic 340-40 applies to the incremental costs of obtaining a contract that fall within the scope of ASC 606 and costs incurred to fulfill a contract within the scope of ASC 606 that are not addressed by another ASC topic.

9.2 Costs to fulfill a contract

If there is other guidance in the ASC that applies to the costs incurred to fulfill a contract within the scope of ASC 606, that other guidance should be applied. Examples of other guidance on how to account for costs that may be involved in the fulfillment of a contract are listed in the following table:

ASC	Type of fulfillment cost
330	Inventory
340-10-25-1 to 25-4	Preproduction costs related to long-term supply contracts (see Section 13.1.1.1)
350-40	Costs of internal-use software
360	Costs related to property, plant and equipment
720-35-25-1A	Certain advertising expenditures incurred after revenue is recognized (e.g., cooperative advertising)
946-720-25-3	Offering costs of advisors of both public and private funds
985-20	Costs of software to be sold, leased or marketed

Note 1: Prior to applying the guidance noted, it is important to understand the specific scope provisions of the guidance to ensure it is applicable to an entity and the specific cost being evaluated.

If the guidance in the table or other specific guidance is applicable to a fulfillment cost incurred by the entity, it must be applied. ASC 340-40 is only applicable to costs to fulfill a contract when there is no other applicable guidance. For example, if there are setup costs that do not fall within the scope of the preproduction cost guidance in ASC 340-10 or other guidance in the ASC, then such costs would be accounted for in accordance with ASC 340-40.

If certain criteria are met, fulfillment costs within the scope of ASC 340-40 must be capitalized. A franchise entity may not choose to expense such costs when the criteria are met.

9.3 Costs to obtain a contract

The incremental costs to obtain a specific contract within the scope of ASC 606 are those costs that would not have been incurred if the contract was not obtained, such as a sales commission. For a cost to be considered an incremental cost of obtaining a contract, the franchisor must be obligated to make a payment only as a result of entering into the contract. The incremental costs to obtain a contract should be capitalized if the franchisor expects to recover those costs (i.e., the net cash flows of the contract and expected renewals will cover the costs). However, a franchisor may elect a practical expedient that allows it to expense the incremental costs to obtain a contract if the amortization period for those costs would otherwise be one year or less.

Costs to obtain a contract within the scope of ASC 606 that are not incremental are those costs related to obtaining the contract that would have been incurred even if the contract was not obtained (e.g., travel costs incurred to present a proposal to the customer). These costs should only be capitalized if they are explicitly chargeable to the customer regardless of whether the franchisor enters into a contract with the customer. Otherwise, such costs are expensed as incurred.

9.4 Amortization and impairment of capitalized costs

ASC 340-40 provides guidance on amortizing costs capitalized in accordance with its provisions as well as testing those capitalized costs for impairment. This guidance is summarized and illustrated in Sections 13.3 and 13.4 in our revenue recognition guide.

10. Disclosures

Many qualitative and quantitative disclosure requirements are included in ASC 606-10-50 and ASC 340-40-50. ASC 606-10-50-1 states the following as the overall disclosure objective of ASC 606 (which is also the overall disclosure objective of ASC 340-40): “The objective of the disclosure requirements in this Topic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.” In general, franchisors are required to disclose a variety of information about the contracts they have with customers and significant judgments used in the application of the guidance.

The disclosures required to achieve this objective focus on providing a variety of revenue-related information. Some of the information that must be disclosed is high-level, such as the amount of revenue recognized from customer contracts and the amount of any impairment (or credit) losses recognized on receivables or contract assets related to customer contracts. However, there is also a significant amount of detailed information that must be disclosed annually related to customer contracts, including information about:

- Disaggregated revenue
- Contract assets, contract liabilities and receivables
- Performance obligations
- Transaction price allocated to remaining performance obligations at the end of the reporting period (disclosures required for public entities and elective for nonpublic entities)
- Significant judgments about the timing of satisfying performance obligations
- Significant judgments about the transaction price and the amounts allocated to performance obligations
- Practical expedients (disclosures required for public entities and nonpublic franchisors, elective for nonpublic entities)

- Capitalized costs related to obtaining or fulfilling a customer contract (disclosures required for public entities and elective for nonpublic entities)

The nature and extent of the required disclosures in each of the preceding categories depends on whether the franchisor is a public entity (more required disclosures) or nonpublic entity (fewer required disclosures). In addition, while more disclosures are required for annual periods, some disclosures also are required for interim periods. However, when a franchisor applies ASC 606 and 340-40 in its interim financial statements for one or more interim periods before it applies ASC 606 and 340-40 in its annual financial statements, the franchisor must provide all the required annual disclosures in those interim financial statements.

Detailed discussion and illustrations of the disclosure requirements for both public and nonpublic entities are included in Chapter 15 of our revenue recognition guide.

10.1 Franchisor practical expedients

If a public franchisor elected either of the following practical expedients, it should disclose that the practical expedient results in not reflecting a significant financing component in the transaction price (refer to Section 5.1) or results in not capitalizing certain incremental costs related to obtaining a contract (refer to Section 9). As applicable, nonpublic entities may elect to make these disclosures.

A nonpublic franchisor that elects to use the practical expedient as noted in Section 4.2.3 should disclose that fact. Additionally, a nonpublic franchisor that makes the accounting policy election to recognize pre-opening services as a single performance obligation should disclose that fact.

+1 800 274 3978
rsmus.com